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Harnessing data to map fund manager exposures to material ESG risks

Will Bryant of Albourne outlines a cutting-edge technique to identify exposures to material ESG risks.

Albourne continues to observe investors focusing on responsible investment and a requirement for fund managers to integrate financially material environmental, social and governance (ESG) factors in the investment process. In response to this need, Albourne believes that an evolving and viable solution to understand exposure is to harness Open Protocol information (standardised risk reporting information by asset class) by mapping it onto the Sustainability Accounting Standards Board's (SASB)[1] materiality matrix. There are several moving parts to understanding why harnessing ESG transparency is so important; this article breaks down some key questions Albourne often gets asked.

Where are we today?

Within the alternatives space, particularly in relation to hedge funds, the adoption of ESG remains in a nascent state, with investors and fund managers looking to define what responsible investing means in the context of a number of different strategy approaches across a range of asset classes, where a traditional approach to responsible investment may not be obvious.

It's now a year since Albourne wrote the article 'Standardise to Sustain' in the HFM ESG Special Report, and while much has been written and discussed since then, the evolution of standardised data availability has not progressed significantly. That said, there have well-publicised initiatives by large asset managers supporting specific frameworks to achieve a more standardised approach to the reporting of data. Further, regulators have been looking more closely at corporate ESG reporting with the European Commission's consultation on Non-Financial Reporting Directive.

Demand for standardised relevant information to be available for use by investors when looking to more systematically integrate ESG information within their investment process is increasing. However, a widely recognised standard framework that can be used as an input to the investment process is yet to emerge, meaning that a standard framework to be used to report on the output of the investment process is also not available. Investors, on the other hand, are looking to meet future stakeholder requirements and are aware that portfolio-level reporting will be necessary.

What are the issues around reporting?

The lack of consistent and comparable data from underlying issuers means reporting is a contentious issue. This is exacerbated in the world of alternatives, which are often actively managed, can be benchmark agnostic, and where managers often invest in order to either harness the price move from corporate change or even to elicit that change through direct engagement or action.

While more alternative managers are implementing some level of ESG reporting, which is to be commended, this reporting is not typically in a format that asset owners can aggregate across their portfolio to get a holistic view of the ESG factors and issues affecting their portfolio.

Reporting is frequently in the format of case studies, discussing in a qualitative manner how ESG has been integrated into the investment decision, or how through active engagement the fund manager is looking to influence the asset's ESG activities. Case studies only address a subset of the portfolio and allow for some level of cherry picking of what is presented and are not in a format capable of aggregation.

Other managers, typically at the impact end of the spectrum, do look to report on all assets in their portfolio and use quantitative metrics. However, due to the specificity of the key performance indicators that the manager selects at the outset of the investment, these are difficult to aggregate.

The UN-supported Principles for Responsible Investment (PRI) has 'reporting' as one of the six principles that signatories commit to follow: "Principle 6: We will each report on our activities and progress towards implementing the Principles"[2]. For many, the extent of their reporting is the PRI's own annual transparency report[3]. The PRI reporting is available online; however, the detail around ESG integration is typically in the form of a descriptive response that does not allow for portfolio-level aggregation.

How do Open Protocol and the Materiality Matrix provide a solution?

Open Protocol is a reporting framework that came about within the hedge fund industry in the wake of the financial crisis of 2008. At that time, investors were looking for greater consistency in the reporting received from fund managers, so that they could collect, collate and compare information in a consistent format.

The Open Protocol[4] framework consists of a template to enable fund managers to produce consistent reports in compliance with a detailed manual. Open Protocol was created by an independent working group of investors, fund managers and service providers. As of mid-2020, Albourne was aware of 685 funds producing reports using the Open Protocol template, representing assets of just under $1.5trn. The funds producing this Open Protocol reporting include alternative and traditional asset managers.

Open Protocol is structured in a format such that almost any investment vehicle can provide reporting via the Open Protocol framework. The basis of Open Protocol reporting is that managers provide standardised information on their exposures by asset class (equity, sovereign fixed income, credit, etc.) based on different characteristics that are relevant to each asset class (sector, market capitalisation, credit rating, country, etc.). The key utility of Open Protocol is that the standard framework allows for simple comparison and collation of the data, such that information can be aggregated to provide a holistic portfolio view. This allows investors to easily view their portfolio exposures to an asset class, sector or country. While Open Protocol does not capture any specific ESG information (such as CO_2 emissions, climate scenario testing or ESG ratings) it does provide a framework for mapping current exposures to potential risk areas from an ESG perspective.

SASB looks to set a reporting standard for corporates to report financially material sustainability or 'extra-traditional' financial data, by creating its materiality map[5]. This map is becoming a market standard with regards to what sustainability factors or issues are likely to materially affect the financial or operating performance of a company based on its sector. The materiality map looks at various topics under multiple dimensions, such as air quality and energy management under the 'environment' and then determines the likelihood by sector of the issue being financially material. By mapping this framework of sector material issues to the sector information provided through Open Protocol, investors can get an understanding of which funds and portfolios have significant exposure to material ESG issues. For example, a portfolio that has high exposure to healthcare or technology would show high exposure to data security as a material ESG issue, but low exposure to air quality relative to transportation.

It is therefore proposed to map Open Protocol sector exposure information to the SASB sector materiality matrix. This will give investors the ability to understand exposures within their funds and portfolios to potential material ESG issues.

What can using existing frameworks provide investors?

The approach laid out above maps exposures, via a format that can be aggregated at a portfolio level, with a framework that has been developed in order to think about the financially material ESG issues. This represents an interim solution for asset owners while further work is carried out on the provision of standardised ESG data, which will permit reporting in a standardised format.

Keeping true to several famous philosophers including Voltaire, who cited that "the best is the enemy of the good", it is clear that the path of responsible investing is an evolving one. Reporting is an important step along that path and will improve over time, but at this point, Albourne believes that the mapping of exposures to material ESG issues through an established framework is a good step forward as the industry creates a new and standardised approach to ESG reporting that is acceptable and relevant to stakeholders.

[1] www.sasb.org
[2] www.unpri.org/pri/an-introduction-to-responsible-investment/what-are-the-principles-for-responsible-investment
[3] www.unpri.org/signatories/reporting-for-signatories
[4] www.sbai.org/toolbox/open-protocol-op-risk-reporting
[5] https://materiality.sasb.org